United States Court of Appeals

for the Second Circuit

SUPPLEMENTAL BRIEF

75-7203

[PRINTED VERSION]

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FOR THE SECOND CIRCUIT

ABRAHAMSON, et al.,

Plaintiffs-Appellants,

v.

FLESCHNER, et al.,

Defendants-Appellees.

SUPPLEMENTAL BRIEF OF THE SECURITIES
AND EXCHANGE COMMISSION, AMICUS CURIAE

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PRELIMINARY STATEMENT

On February 25, 1977, the Court entered its decision in this appeal, holding, among other things, that

(1) the general partners of defendant Fleschner Becker Associates ("FBA") are investment advisers, as that term is defined in Section 202(a)(11) of the Investment Advisers Act of 1940;

(2) there is an implied private right of action for damages due to violations of the antifraud provisions of Section 206 of the Investment Advisers Act and Rule 206(4)-1 thereunder, and the complaint states a cause of action under that Section and Rule; and

(3) the complaint alleges compensable damages under the Act. 1/

Petitions for rehearing, and suggestions for rehearing en banc, were

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1/ Abrahamson v. Fleschner, ___ F.2d ___, [Current] CCH Fed. Sec. L. Rep. ¶95,889. The facts that are relevant to this appeal, which the Court found were not in dispute, are set forth in the Court's decision, id. at pp. 91,270-91,271, and will not be repeated in this brief.

filed by the defendants-appellees, which were supported by several amici curiae. On April 15, 1977, the Court entered an order, requesting the plaintiffs and the Commission to furnish the Court with supplemental briefs discussing the issue of whether the general partners of defendant Fleschner Becker Associates are investment advisers within the meaning of the Investment Advisers Act of 1940. 2/ The Securities and Exchange

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2/ The Court expressly limited its request to the issue specified in the text and, accordingly, the Commission does not address in detail any other issue.

For the reasons set forth in our initial brief, filed in January, 1976, the Commission agrees with the decision of the majority that a private right of action is implied by the antifraud provisions of the Investment Advisers Act, and that the complaint alleges compensable damages.

Recognizing the limited issues raised by this Court's order, we feel constrained to note, in passing, our belief that the Court may have erred in dismissing the plaintiffs' cause of action predicated upon Securities Exchange Act Rule 10b-5.

While the Commission did not address this issue in depth in its initial brief, we did observe that, "[i]f the factual allegations of the complaint are analyzed in terms of the many securities transactions that occurred, and not merely the plaintiffs' entry into and withdrawal from the partnership, it appears that the 'in connection with' test is satisfied." Commission Br. at 33 n.39. As this Court noted with respect to an analogous situation in Arthur Lipper Corp. v. Securities and Exchange Commission, 547 F.2d 171, 176 (1976) the type of fraud alleged by the plaintiff herein "relates not, as in the usual case, to a particular securities transaction but to a course of dealing in securities regardless of their identity."

Accordingly, in Lipper, Judge Friendly held that the language of Rule 10b-5 was "broad enough" to include such conduct, and that there was nothing in the Supreme Court's recent decision in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), "that would militate against application of the Rule in a situation like that here before us." In this case, however, the Court held, in reliance on Blue Chip Stamps, that the complaint did not state a cause of action under Rule 10b-5. [Current] CCH Fed. Sec. L. Rep. at pp. 91,271-91,272.

Commission files this supplemental brief as amicus curiae in response to the Court's order.

ARGUMENT

I. THE GENERAL PARTNERS OF FBA ARE INVESTMENT ADVISERS, WITHIN THE MEANING OF THE INVESTMENT ADVISERS ACT OF 1940.

As the Commission pointed out in its initial brief in this appeal, 3/ only by relying upon a strained, technical, and restrictive construction of the term "investment adviser," as employed in the federal securities laws, 4/ could the defendants here seek to avoid the application of the antifraud provisions of the Investment Advisers Act to their conduct. 5/ The defendant general partners are investment advisers within the contemplation of both law and common sense.

3/ See Commission Br. at 9-12. The Commission's initial brief will be cited hereafter as "Comm. Br. __;" the petition for rehearing of FBA and its general partners will be cited "FBA Br. __;" and the briefs of amici A. W. Jones & Associates and Steinhardt, Berkowitz & Co. will be referred to, respectively, as "A. W. Jones Br. __" and "Steinhardt Br. __". The Investment Counsel Association of America, Inc., also filed an amicus brief, limited to a discussion of the implied right of action under the Investment Advisers Act.

4/ Section 202(a)(11) of the Investment Advisers Act defines the term "investment adviser" as including

> "any person who, for compensation, engages in the business of advising others, either directly or through publication or writings, as to the value of securities or who, for compensation and as a part of a regular business, issues or promulgates analyses or reports concerning securities * * *."

5/ In this case, this Court is faced solely with the question whether the defendants were investment advisers for purposes of the antifraud provisions of the Investment Advisers Act. This action does not raise, nor do we opine, whether the registration requirements of the Act were applicable to these defendants. See pp. 16-21, infra.

Defendant FBA is a partnership, the principal purpose of which is to invest and trade in securities. The general partners of FBA, including defendants Fleschner, Becker and Ehrlich, had, and have, the sole power to make investment decisions for the partnership. The general partners had, and have, the power to carry out the objects and purposes of the partnership, including the power

> "to invest and trade, on margin or otherwise, in capital stock, preorganization certificates and subscriptions, warrants, bonds, notes, debentures, whether subordinated, convertible or otherwise, trust receipts and other securities of whatever kind * * * and in commodities and commodities contracts * * *." App. 89a. 6/

It Makes No Difference That the General Partners Directly Managed the Investments of Others Rather Than Merely Advised Others; Congress Intended Both Types of Services to be Encompassed Within the Definition of "Investment Adviser."

As this Court held in its previous consideration of this case, "that the general partners as persons who manage the funds of others for compensation are 'investment advisers' * * * is borne out by the plain language of Section 202(a)(11) and its related provisions, by evidence of legislative intent and by the broad remedial purposes of the Act." [Current] CCH Fed. Sec. L. Rep. at 91,272. Various provisions of the Act reflect the awareness in 1940 that many investment advisers "advise" their customers by exercising control over their clients' funds. Section 202(a)(11) must be read in conjunction with these other sections, including Section 205 and Section 203(c)(1)(D). And, as we indicated in our initial brief (pp. 11-12), the legislative history of the Investment

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6/ References to the joint appendix originally filed in this appeal are cited as "App. ___".

Advisers Act reinforces the meaning of these statutory provisions, and indicates that the definition of the term investment adviser was meant to include persons, such as the general partners of FBA, who manage the funds of others for compensation and exercise complete discretion over the investments made with those funds.

Thus, for example, the Investment Advisers Act was based on a survey of investment advisers by the Securities and Exchange Commission made in connection with its study of investment trusts and investment companies. 7/ That Report, published as a supplement to the Commission's study on investment companies, noted that there were two types of services rendered by investment advisers to their clients, that is, "discretionary" or "advisory" services. The Commission Report explained,

> "Discretionary powers imply the vesting with an investment counsel firm control over the client's funds, with the power to make the ultimate determination with respect to the sale and purchase of securities for the client's portfolio." 8/

As this Court observed, [Current] CCH Fed. Sec. L. Rep. at 91,273, the Commission Report

> "noted the conspicuous need for regulation of individuals 'who may solicit the funds of the public to be controlled, managed, and supervised * * *.' SEC Report at 28 (emphasis added). The

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7/ Securities and Exchange Commission, Investment Counsel, Investment Management, Investment Supervisory and Investment Advisory Services, H.R. Doc. No. 477, 76th Cong., 2d Sess. (1939) [hereinafter cited as "Commission Report"].

8/ Commission Report at 13 (emphasis supplied). "Advisory" powers, by contrast, empowered an adviser merely to "make recommendations to its client, with whom rests the ultimate power to accept or reject such recommendations." Id.

> report made it clear that its findings and recommendations were intended to cover persons who made purchases and sales of securities with their clients' funds."

The House and Senate Committee reports on the legislation that became the Investment Advisers Act indicate that Congress' intent was consistent with the recommendations of the Commission. 9/

Thus, it is of no consequence that the general partners of FBA provided "discretionary" management services to the limited partners through the partnership, rather than purely "advisory" services. 10/ For, as we have seen, in designing legislation which would provide a "solution of the problems and abuses of investment advisory services," Congress included within the scope of its regulatory scheme advisers exercising either type of power.

9/ The Report of the Senate Committee on Banking and Currency stated that the Commission Report had shown, consistent with "the record before the committee," that

> "the solution of the problems and abuses of investment advisory services — individuals and companies which either handle pools of liquid funds of the public or give advice with respect to security transactions -- cannot be effected without Federal legislation."

S. Rep. No. 1775, 76th Cong., 3d Sess. 21 (1940); see also, H.R. Rep. No. 2639, 76th Cong., 3d Sess. 27 (1940). That Congress intended its legislation to reach those who managed their clients' funds is reaffirmed in the legislative history of the 1960 Amendments to the Investment Advisers Act. See S. Rep. No. 1760, 86th Cong., 2d Sess. 4 (1960).

10/ The general partners briefly attempt to argue this point, contending that they "did not purport to, and did not advise the limited partners * * *. Rather, they invested the undivided partnership interests." FBA Br. 5-6 (emphasis supplied). That activity is, as the legislative history cited by the Court in its initial opinion indicates, exactly the type of activity the Investment Advisers Act was intended to reach -- the management of "pools of liquid funds."

Other Purported Distinctions Advanced With Respect to FBA are Irrelevant to the Question of Whether the General Partners are Investment Advisers.

In their petition for rehearing, the general partners argue that they are not investment advisers, but "managers of their own privately-held business operating in the partnership form." FBA Br. 5. They then cite a number of "critical facts" with respect to FBA that are apparently intended to demonstrate this purported distinction. But, there is no reason why a manager of his own "privately-held business operating in the partnership form" cannot also be an investment adviser; 11/ and the "critical" facts cited by the general partners do not afford any basis for the conclusion that they are not within the meaning of the term "investment adviser."

All of the facts cited are simply irrelevant. Thus, it makes no difference that the general partners provided services, through the partnership, primarily or even solely to relatives and "friends"; that the partnership invested "only its own funds" (that is, funds obtained from the limited partners); or that the general partners themselves invested some of their own money through the partnership. FBA Br. 5-6. 12/

11/ A partnership may of course be an investment adviser. The term "person" used by the Act in the definition of the term investment adviser is defined in Section 202(a)(16) to include a "company," which is in turn defined in Section 202(a)(5) as including a "partnership." The statutory term "person associated with an investment adviser" is defined as including "any partner * * * of such investment adviser." Section 202(a)(17).

12/ A. W. Jones, in its amicus brief, also argues that the fact that a general partner also invests through the partnership produces a "community of interest and the elimination of conflict of interest between a general partner and the limited partners * * *." A. W. Jones Br. at 3. We cannot agree; see 1 Securities and

(footnote continued)

Equally irrelevant is the general partners' claim that, because they assumed the "full risk" of the partnership's liabilities, their business stands "in sharp contrast to the kind of riskless activity by investment advisers which Congress sought to regulate under the [Investment Advisers] Act;" as we noted supra, note 11, an investment adviser may operate in the partnership form, and the liabilities of such entities are always assumed by the general partners. 13/

Similarly, it does not matter that the general partners might have also been subject to the "reach of state law remedies for breach of any duty owed to the limited partners," 14/ since Congress, as the Supreme Court recently observed, "intended the Investment Advisers Act

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12/ (continued)

Exchange Commission, Institutional Investor Study Report, H.R. Doc. No. 92-64, 92 Cong., 1st Sess., p. xv (1971) (hereinafter "Institutional Report"). The mere fact that two persons pool their funds in a joint investment does not automatically eliminate all conflicts of interest, since the two persons may have different investment objectives. Indeed, that is the basis for the plaintiff's claim in this case — that the managers of the fund wanted to invest in a more speculative fashion than they were willing to disclose to the limited partners. The issue is, in any event, irrelevant; people have been found guilty of fraud even though they lacked inherent conflicts, and had a seeming community of interests, with their victims. See, e.g., Securities and Exchange Commission v. Texas Gulf Sulphur Co., 401 F.2d 833 (C.A. 2, 1968), certiorari denied, sub nom. Coates v. Securities and Exchange Commission, 394 U.S. 976 (1969).

13/ If the general partners of FBA are, however, implying that they incur an unusual amount of risk because of the nature of the partnership's investments, we think that that would only be one more reason why the limited partners of FBA are in need of the protections of the antifraud provisions of the Investment Advisers Act.

14/ FBA Br. at 6; see also Steinhardt Br. at 10 and n.13.

to establish federal fiduciary standards for investment advisers." Santa Fe Industries, Inc. v. Green, ___ U.S. ___, 45 U.S.L.W. 4317, 4320 n.11 (Mar. 23, 1977). 15/ Accord, Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1975) ("* * * there is redress under §10(b), whatever might be available as a remedy under state law.") Finally, the general partners' contention that there is no "evidence" that they "held themselves out to the public as offering investment advice through FBA," id., even if true, would be relevant only to the issue of whether they had to register with the Commission as investment advisers 16/ — an issue which, as we indicate infra, page 16-21, is not relevant to this particular appeal, since the antifraud provisions of the Investment Advisers Act apply to all advisers, whether required to register or not.

Exemptions From the Definition of the Term Investment Adviser Given by the Commission to Certain Applicants in the Past, Under Particular Facts, on the Ground that Such Applicants Were Not "Within the Intent" of the Definition of Investment Adviser, Have No Bearing on the General Legal Question in this Case.

The general partners and amici, in arguing that the general partners of FBA are not investment advisers, rely on a number of Commission

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15/ The Santa Fe decision recognizes that traditional notions of equitable fraud impose a high standard of conduct on advisers when dealing with their clients. 45 U.S.L.W. at 4320 n.11, citing, Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191-192 (1963). The fundamental distinction cited by the Supreme Court between Section 10(b) of the Securities Exchange Act and Section 206 of the Investment Advisers Act in the Santa Fe case suggests that this Court's statement, in this case, that scienter is an element of an implied private damage action under Section 206 is questionable. As the Court noted, however, scienter is not an issue in this case, since the complaint alleges intentional misrepresentations.

16/ An investment adviser is exempt from the registration requirements if it has fewer than fifteen clients and "neither holds himself out generally to the public nor acts as an investment adviser to any [registered] investment company * * *." Section 203(b)(3) of the Investment Advisers Act.

rulings which did not involve limited partnerships but which, they claim, "establish that general partners of an internally managed partnership such as FBA were not intended by Congress to be regarded as 'investment advisers.'" FBA Br. p. 7-8; see also, Steinhardt Br. at 9. In this regard, they rely principally on three Commission orders entered in response to specific applications seeking individual rulings, pursuant to Section 202(a)(11)(F) of the Investment Advisers Act, 17/ that the applicants should not be treated as persons "within the intent" of the definition of investment adviser. 18/ In re Roosevelt & Son, Investment Advisers Act Release No. 54 (Sept. 2, 1949), [1948-1952] CCH Fed. Sec. L. Rep. ¶76,016 (1949); In re Pitcairn Company, Investment Advisers Act Release No. 52 (Mar. 7, 1949), [1948-1952] CCH Fed. Sec. L. Rep. ¶75,990 (1949); and In re Loring, 11 S.E.C. 885 (1942).

17/ The section authorizes the Commission to exclude any specific person or any generic category of persons from the term "investment adviser" if the Commission finds that "such other persons [are] not within the intent of the paragraph * * *." The Commission has promulgated one such rule of general applicability, exempting from the definition "any person who offers investment advice to an employee benefit plan * * * sponsored by an employor of such person, if such person is not engaged in the business of providing investment advice or management to others * * *." Rule 202-1, 17 CFR 275.202-1.

18/ The very language of Section 202(a)(11)(F) makes evident that applicants who seek the exercise of the Commission's exemptive powers would, in the absence of Commission action, be "investment advisers" within the literal terms of the statutory definition. The statutory provision itself contains examples of such persons -- for example, professionals whose advisory services are rendered only incidentally to the practice of a profession, and bona fide newspapers or magazines. See Section 202(a)(11)(B), (D). The authority to exempt other persons or classes of persons was given to the Commission to provide a means to exempt categories which Congress had inadvertantly neglected to exclude, as well as specific individuals who, because of particular factual circumstances, were not "within the intent" of the definition.

Since each of these orders related solely to the specific activities there before the Commission, they are not of precedential effect. Only generic exemptions, adopted by rules such as Rule 202-1 (see supra n.17), would serve such a purpose. See, e.g., PBW Stock Exchange, Inc. v. Securities and Exchange Commission, 485 F.2d 718, 732 (C.A. 3, 1973), certiorari denied, 416 U.S. 969 (1974). But, in any event, the management and advisory relationships involved in those orders were significantly different from those found in this case. In Roosevelt, over two-thirds of the accounts maintained were maintained with the Roosevelt brothers, the general partners, in their capacity as executors and testamentary trustees of estates and trusts in which various members of the Roosevelt family had an interest or were beneficiaries. The firm, the successor to a business carried on since 1792, was in the process of converting all of its non-trust accounts containing securities to a trust basis with one or both of the general partners as trustee, or co-trustees in those instances where the donor or some member of his or her family would be a co-trustee; and the number of non-family accounts had been steadily declining.

In Pitcairn, the entity in question was a close corporation, 60 percent of the common stock of which was owned by three brothers. 19/ All the stockholders (except for four churches holding less than three percent of the stock), all the living beneficiaries of trusts holding any stock, and all the trustees thereof (except for three individuals, of whom two were officers of Pitcairn and a third the company's counsel)

19/ The business of the company consisted of the management and investment of the company's funds and the manufacture and sale of valves and fittings. [1948-1952] CCH Fed. Sec. L. Rep. at p. 78,416.

were spouses, descendants, or spouses of descendants of one of the three brothers. The advisory services supplied by Pitcairn were performed substantially at cost.

Finally, in Loring, the Commission granted the exemptive application of a person who was in the business of "acting as a court fiduciary, i.e., trustee, guardian, conservator, or executor under wills or other instruments filed with and under the supervision of the courts." Of the total value of the property which Mr. Loring administered, 78 percent was under court appointment or irrevocable indentures. In those situations where Mr. Loring acted as trustee under court appointment, his compensation was set by the court. 20/

Each of these three Commission orders involved the granting of an application for an exemptive order pursuant to Section 202(a)(11)(F) of the Advisers Act, determining that the particular applicant was not "within the intent" of the definitional provision. The Commission did not indicate in these orders that trustees or close corporations --

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20/ In citing each of these three orders, the Commission emphasized that the applicant did not solicit new accounts and had no intention of enlarging the group to which it provided services. These static entities are not comparable to FBA, which has been expanding ever since its inception.

The substantial compensation received by the general partners in FBA ($25,000 annually plus 20 percent of the net profits and net capital gains) is another indication that the management and advisory services they provided were generically different from the services provided by the advisers in the cases they rely on. In Roosevelt, the firm was compensated for all its services by a three percent charge on collections or income, in addition to the partners individually receiving fiduciary commissions on the testamentary trusts or estates; in Pitcairn, the advisory services were performed substantially at cost; and in Loring, the trustee's compensation was set by the court.

or any other types of entity -- are generally not investment advisers, but only that the particular applicant involved was entitled to an exemptive order. Such orders are necessarily based on the particular circumstances of each case and do not apply to other persons.

Neither FBA nor its general partners (nor, for that matter, the general partners of any other hedge fund) have sought an exemptive order from the Commission; and the defendants' attempt to generate some precedent for their interpretation of the law from orders of particular application, each of which is nearly or over three decades old, is some evidence of the weakness of their legal contentions. These exemptive orders were based on factual circumstances that are significantly different from the facts with respect to FBA, and they do not support the conclusion for which the defendants argue. 21/

21/ Defendants also rely upon the decision of the district court in Selzer v. Bank of Bermuda, Ltd., 385 F.Supp. 415 (S.D. N.Y., 1974), in which the court held that the "Investment Advisers Act is not available in a suit against a trustee" by a beneficiary of the trust in question. In the court's view, it was significant that the "trustee does not advise the trust company, which then takes action pursuant to his advice; rather the trustee acts himself as principal." Accordingly, the court believed, "neither the common sense meaning of the word 'adviser' nor a comparison with other situations to which the 1940 Act has been held applicable militates in favor of doing so." 385 F.Supp. at 420. Purporting to rely on the Commission's order in Loring, which the court interpreted as holding that a trustee was not an investment adviser, the court found that a recent "no-action" letter written by the Commission's staff, Brewer-Burner & Associates, Inc., [1973-74] CCH Fed. Sec. L. Rep. ¶79,719 (where the Division of Investment Management opined that a foreign trustee of foreign trusts set up by American investors would be an investment adviser) "conflict[ed] with a much earlier opinion [Loring] by the Commission * * *."

(footnote continued)

The Fact that Internal Managers of Registered Investment Companies are Excluded From the Definition of "Investment Adviser" of an Investment Company is Irrelevant to the Question of Whether General Partners of Hedge Funds are Investment Advisers Under the Investment Advisers Act.

Finally, in its amicus brief, Steinhardt constructs an argument purportedly based on the need to read the Investment Advisers Act "in conjunction with, and ancillary to, the Investment Company Act." 22/ What this apparently means to Steinhardt is that the two Acts should be read in a manner that would allow general partners of hedge funds to escape coverage by either Act. Steinhardt's reading of the statutes, however, is not consistent with the way in which the Commission has interpreted these statutes nor, we submit, is it consistent with the intent of Congress.

In its brief, Steinhardt strongly urges that, because the Investment Company Act excludes officers, directors, and other internal managers of registered investment companies from the definition contained in that Act of of the term "'investment adviser' of an investment company," 23/

21/ (footnote continued)

The district court's interpretation of the "common sense" meaning of the term "investment adviser," however, conflicts with this Court's holding, in this case, that the "plain language of Section 202(a)(11) and its related provisions" indicates that the general partners of FBA should be held to be investment advisers. Moreover, in focusing upon the "common sense" meaning of the statute, the district court left completely unexamined the substantial and persuasive body of legislative history indicating that that term was intended to encompass both those who "managed" or "supervised" pools of liquid funds and those who gave advice to the public with respect to securities.

22/ Steinhardt Br. at 4.

23/ See Section 2(a)(20) of the Investment Company Act of 1940, 15 U.S.C. 80a-2(a)(20).

it should logically follow that Congress intended to exclude from the definition of the term investment adviser set forth in the Investment Advisers Act the internal managers of all self-managed investment vehicles. Steinhardt Br. at 4-11. But, officers, internal managers and employees of registered investment companies are excluded from the definition of investment adviser in the Investment Company Act because the investment company itself is a registered entity which is subject to extensive regulation and because other obligations imposed upon the affiliated persons of a registered investment company -- including its internal advisers -- were deemed by Congress to be adequate to achieve the purpose of protecting investors in such companies. 24/ Specifically, internal advisers and other employees and affiliated persons of registered investment companies are subject to Section 36(a) of the Investment Company Act, providing liability for breaches of fiduciary duty involving personal misconduct. In addition, other provisions of the Investment Company Act apply with equal force to the employees and affiliated persons of internally managed investment companies as to those with external advisers. For example, Section 17 of the Investment Company Act broadly prohibits transactions involving self-dealing. The interpretation for which Steinhardt argues, however, would exempt the general partners from the antifraud provisions of the Investment Advisers Act, with no provision for any

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24/ It appears that the definition of "investment adviser" contained in the respective Acts were not intended to be entirely consistent with each other. For example, the exclusion from the definitions in each statute are very different. Persons excluded by the clauses of Section 2(a)(20) of the Investment Company Act are, however, subject to the Advisers Act if they meet the criteria of Section 202(a)(11) of that Act.

other responsibilities. 25/ The suggestion that Congress provided a "solution to the problems and abuses of investment advisory services" by enacting a legislative scheme that creates the mere illusion of protection for investors cannot be correct.

II. CONTRARY TO ARGUMENTS MADE BY DEFENDANTS AND AMICI, THE COMMISSION HAS NEVER TAKEN THE POSITION THAT GENERAL PARTNERS OF AN INVESTMENT PARTNERSHIP SUCH AS FBA ARE NOT INVESTMENT ADVISERS.

It is not true, as the general partners state, that the Commission has "held [investment entities such as FBA] not subject to the [Investment Advisers] Act." FBA Br. at 3. The general partners do not cite any authority for this misstatement, and in fact there is nothing that would support it.

The Commission has, of course, been aware of the existence of hedge funds, particularly since this type of investment vehicle became more popular in the middle 1960's. 26/ By 1968, however, when the Congress

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25/ As Steinhardt points out, in 1970 Congress removed the exemption from registration as an adviser for advisers whose only clients were registered investment companies. Steinhardt Br. 5 n.5, 6 n.8. The legislative history of these amendments makes it clear that Congress intended to expand the coverage of the Investment Advisers Act, to provide the protections of that Act to shareholders of registered investment companies -- not, as Steinhardt suggests, to create a loophole for all internal managers of investment vehicles. See S. Rep. No. 91-184, 91st Cong., 1st Sess. 44-45 (1969); H.R. Rep. No. 91-1382, 91st Cong., 2d Sess. 39-40 (1970). The general partners of FBA were investment advisers before the 1970 amendments, and their status was in any event not affected by the change in the statute.

26/ A. W. Jones & Associates, which has appeared as an amicus herein and which has been recognized as the "modern progenitor of the hedge fund," was formed in 1949 as a general partnership and became a limited partnership in 1952. Hawes, "Hedge Funds -- Investment Clubs for the Rich," 23 Bus. Lawyer 576, 577 (1968).

directed the Commission to conduct an economic study of institutional investors and the effects of their trading on the securities markets and on the interests of issuers and the investing public, 27/ there was still "a dearth of hard information about both individual hedge funds and hedge funds as a group." 28/ The Commission did, as part of its Institutional Investor Study, conduct an inquiry into the activities of hedge funds, and the results of that survey were set forth in its Report. 29/ While the Report was primarily a study of current investment practices which did not purport to set forth regulatory policies, the Commission made the following statement with respect to hedge funds in the transmittal letter which accompanied the Report to Congress:

> "Although hedge funds bear attributes of investment companies and their general partners perform many of the same functions as investment advisers, neither the funds nor their general partners ordinarily are registered under either the Investment Company or the Investment Advisers Act of 1940. The hedge fund's activities might also be construed to bring them within the statutory definition of "dealer" contained in the Securities Exchange Act of 1934.
>
> "As a result of the Study's review of hedge funds operations, it now appears practicable to clarify the applicability to hedge funds of registration requirements under one or more of the Investment Company Act of 1940, the Investment Advisers Act of 1940 and the Securities Exchange Act of 1934, and to formulate any necessary rules regarding such funds under the appropriate securities laws.

27/ Pub. L. No. 90-438, as amended by Pub. L. 91-410.

28/ Institutional Report, supra n. 12, xv.

29/ Institutional Report, 283-342.

> The Commission does not believe that new legislation is required and will take the steps necessary to accomplish this purpose." 30/

The clarification of the need for registration of hedge funds and their general partners to which the Commission referred in its transmittal letter accompanying the Institutional Report was not forthcoming; no rules regarding hedge funds were issued. To some extent, this was due to the fact that the popularity of the hedge fund declined in the 1970's, a decline that has continued to the present. 31/ The managers of hedge funds generally do not register with the Commission

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30/ Institutional Report, xv-xvi (emphasis supplied).

31/ Even at the time it conducted its Institutional Investor Study, the Commission found that hedge funds had markedly decreased in number and size over the period from December 31, 1968, to June 30, 1970. Hedge fund assets had decreased over 70 percent during the period; some funds had distributed all or a portion of their funds; and the number of limited partners had dropped by one-third. Institutional Report at 302. At the present time, accurate data on hedge funds is again hard to obtain; but the Commission knows of no reason to dispute the estimate, at p. 2, n.1 of the Steinhardt brief, that hedge funds are today fewer in number than at the time of its Institutional Report.

The Commission has never found it necessary to bring an enforcement action against a hedge fund or its general partners, although, as indicated in the amicus brief of A. W. Jones, it has investigated at least that one particular hedge fund. It is difficult to ascertain the basis for A. W. Jones' contention, however, that the fact that the Commission closed that investigation without taking enforcement action indicates a "definitive conclusion on the part of the SEC, after due inquiry, that general partners are not 'investment advisers' * * *, and that further action on the issue by the SEC would require legislation." The Commission might have concluded that A. W. Jones' activities did not violate the securities laws; and, of course, the Commission might also have decided not to take action for any of various policy reasons, including the need to allocate manpower and other resources to areas of more pressing concern.

as investment advisers, generally in reliance on an interpretation of the law with respect to the number of clients whom they serve as an adviser. 32/ If the managers of hedge funds are properly viewed as providing investment advice to one client -- the partnership -- then they would not be required to register as investment advisers, assuming they do not hold themselves out to the public as investment advisers. If they are, on the other hand, properly viewed as advising each partner of a partnership having more than fourteen partners, they would be required to register, if no other exemption is available

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32/ To the extent that general partners of hedge funds interpret the law so as to exclude themselves from the definition of the term "investment adviser," the Commission has already indicated its disagreement with that interpretation, in its initial brief in this case. Even prior to that brief, the Commission and its staff had provided ample notice that it believed that managers of hedge funds came within the statutory definition. For example, the Institutional Report, as noted supra n.12, stated that the Commission did not believe that new legislation was needed to enable it to deal with hedge funds. Institutional Report at xvi. While not a Commission position, or even precedent, the Commission's staff had indicated in a 1973 no-action letter, Rami Hofshi, [1973] CCH Fed. Sec. L. Rep. ¶79,441, that a member of an "investment club" elected to a position responsible for making all the club's investment decisions was an investment adviser. See also, Brian A. Pecker, [1974] CCH Fed. Sec. L. Rep. ¶79,997. Articles published concerning hedge funds have generally concluded that the general partners of such entities are advisers. See, Hawes, "Hedge Funds -- Investment Clubs for the Rich," 23 Bus. Lawyer 576, 580 (1968); Berkowitz, "Regulation of Hedge Funds," 2 Review of Securities Regulations, 961, 962 (Jan. 17, 1969). The latter article stated:

> "It seems clear that payment to the general partner of the hedge fund in excess of his pro rata distributive share is compensation for furnishing investment advice. Without some exemption, he will be required to register as an investment adviser and to comply with the other provisions of the Advisers Act."

to them. As pointed out in the Steinhardt brief at p. 13, n.20, it may be that this is an issue of fact dependent upon the particular circumstances with respect to each partnership. In any event, those who act as general partners of hedge funds without registering as advisers are doing so strictly at their own risk; the Commission has to date not indicated in any way its concurrence with, or acquiescence in, the legal position taken by such persons. 33/

Registration, however, is an issue that is not present in this appeal. 34/ Those who come within the statutory definition of "investment adviser" are governed by the antifraud provisions of Section 206 of the Investment Advisers Act, regardless of whether they are required to be registered, and regardless of whether they have in fact registered, if required to do so. The antifraud provisions of the Investment Ad-

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33/ Commentators have reached opposite conclusions with respect to the need for registration. Cf. Berkowitz, supra, n.32, at 962 with Hawes, supra n.32, at 580.

34/ Amici A. W. Jones and Steinhardt argue that the Court's statement that "[t]he general partners as individuals, not FBA as an entity, were the investment advisers to the limited partners." [Current] CCH Fed. Sec. L. Rep. at p. 91,282 n.16 (emphasis added), went beyond that necessary for the court's decision. A. W. Jones Br. at 6; Steinhardt Br. at 11.

The Commission does not disagree that the portion of this statement underlined above is not necessary to the Court's holding. In any event, we believe that the statement is, taken in context, meant to identify the advisers, not the clients. Since it is not necessary for the court to decide whether the general partners had one client (the partnership) or 66 (the limited partners), and since the Commission has not yet taken a position with respect to this question, we respectfully suggest that the Court might consider amending its decision by deleting the underlined portion of the sentence in question.

visers Act apply to "any investment adviser" -- even an adviser with only one client; accordingly, they apply to the general partners of FBA.

CONCLUSION

For the reasons set forth in our initial brief and in this brief, this Court should reaffirm its holding in this case that the general partners of FBA are "investment advisers" within the meaning of the Investment Advisers Act of 1940.

Respectfully submitted,

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May 1977

SECURITIES AND EXCHANGE COMMISSION
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OFFICE OF THE
GENERAL COUNSEL

May 11, 1977

A. Daniel Fusaro, Esquire
Clerk, United States Court of
Appeals for the Second Circuit
U.S. Courthouse
Foley Square
New York, New York 10007

Re: Abrahamson, et al. v. Fleschner, et al., No. 75-7203

Dear Mr. Fusaro:

Enclosed for filing in the above-captioned appeal are ten copies of the final, printed version of the Commission's supplemental brief filed pursuant to the Court's order dated April 15, 1977. The Commission requests that the printed copies be substituted for the page-proof copies, which were mailed to the Court on May 6, 1977.

I hereby certify that two copies of the Commission's supplemental brief were served by mail on this date on counsel for all parties and amici participating in this appeal.

Yours very truly,

J. Schropp

James H. Schropp
Special Counsel

Enclosures